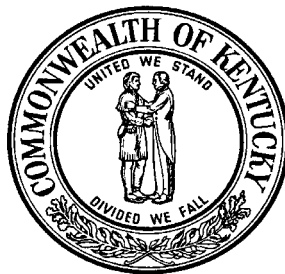


**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS
DEPARTMENT OF EDUCATION**

**In Reference to the Statewide Single Audit
of the Commonwealth of Kentucky**

For the Year Ended June 30, 2004



**CRIT LUALLEN
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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

Gene Wilhoit, Commissioner
Department of Education

MANAGEMENT LETTER

Pursuant to KRS 43.090 (1), which states, "[i]mmediately upon completion of each audit and investigation, except those provided for in KRS 43.070, the Auditor shall prepare a report of his findings and recommendations," we are providing this letter to the Department of Education to comply with KRS 43.090.

The work completed on the Department of Education is part of the overall opinions included in the audit of the Commonwealth of Kentucky's Comprehensive Annual Financial Report (CAFR) and Statewide Single Audit Findings and recommendations for agencies, if applicable, audited as part of the CAFR and Single Audit can be found in the Statewide Single Audit Report. This report can be obtained on our website at www.auditor.ky.gov.

If our audit noted other matters related to the Department of Education, which we believe should be reported to management, those are included in this letter.

Included in the Department of Education's letter are the following:

- ◆ Acronym List
- ◆ Schedule of Expenditures of Federal Awards
- ◆ Notes to the Schedule of Expenditures of Federal Awards
- ◆ Other Matters to Report to Management
- ◆ Summary Schedule of Prior Year Audit Findings

This letter is intended solely for the information and use of management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Crit Luallen".

Crit Luallen
Auditor of Public Accounts

February 28, 2005



LIST OF ABBREVIATIONS/ACRONYMS

APA	Auditor of Public Accounts
CFDA	Catalog of Federal Domestic Assistance
Education	Department of Education
EDU	Department of Education
E-GAPS	Education's Grant Administration and Payment System
FY	Fiscal Year
GOPM	Governor's Office of Policy and Management
JVC	Journal Voucher Correction
KAR	Kentucky Administrative Regulations
KDE	Kentucky Department of Education
KRS	Kentucky Revised Statutes
MARS	Management Administrative Reporting System
OMB	Office of Management and Budget
PRBL	Project Budget Line Inquiry
RE	Receivable Document
SEEK	Support Education Excellence in Kentucky
SEFA	Schedule of Expenditures of Federal Awards

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

CFDA #	Program Title	State	Expenditures		Provided to
		Organizations	Cash	Noncash	Subrecipient
DEPARTMENT OF EDUCATION					
<u>U.S. Department of Agriculture</u>					
Direct Programs:					
Child Nutrition Cluster:					
10.553	School Breakfast Program (Note 2)		\$ 35,722,444		\$ 35,645,044
10.555	National School Lunch Program (Note 2)		110,190,526		110,036,154
10.556	Special Milk Program for Children (Note 2)		88,468		88,468
10.559	Summer Food Service Program for Children (Note 2)		6,154,494		5,984,062
10.558	Child and Adult Care Food Program (Note 2)		24,372,132		23,885,750
10.560	State Administrative Expenses for Child Nutrition		2,368,647		-
<u>U.S. Department of Labor</u>					
Passed Through From the Cabinet for Workforce Development:					
17.258	WIA Adult Program		1,035,266		945,874
<u>U.S. Department of Education</u>					
Direct Programs:					
84.010	Title I Grants to Local Educational Agencies (Note 2)		172,020,243		171,126,606
84.011	Migrant Education - State Grant Program		7,807,782		7,681,669
84.013	Title I Program for Neglected and Delinquent Children		2,916		-
Special Education Cluster:					
84.027	Special Education - Grants to States (Note 2)		114,867,690		112,538,361
84.173	Special Education - Preschool Grants (Note 2)		10,981,242		9,756,372
84.184	Safe and Drug-Free Schools and Communities: National Programs		721,923		721,923
84.185	Byrd Honors Scholarships		533,727		120,000
84.186	Safe and Drug-Free Schools and Communities - State Grants		6,246,832		5,956,726
84.194	Bilingual Education Support Services		70,798		70,798

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

CFDA #	Program Title	State	Expenditures		Provided to
		Organizations	Cash	Noncash	Subrecipient
84.196	Education for Homeless Children and Youth		622,791		621,977
84.213	Even Start - State Educational Agencies		2,721,298		2,498,613
84.215	Fund for the Improvement of Education (Note 3)		531,886		516,031
84.216	Private School - Capital Expenses		39,299		39,299
84.281	Eisenhower Professional Development State Grants		955,173		423,246
84.287	Twenty-First Century Community Learning Centers		5,933,325		5,889,392
84.293	Foreign Language Assistance		29,587		-
84.298	State Grants for Innovative Programs		6,024,213		5,656,592
84.318	Education Technology State Grants		8,127,071		7,678,501
84.323	Special Education State Program Improvement Grants for Children with Disabilities		1,093,965		1,089,558
84.326	Special Education - Technical Assistance and Dissemination to Improve Services and Results for Children with Disabilities		157,107		157,106
84.327	Special Education - Technology and Media Services for Individuals with Disabilities		69,822		69,822
84.330	Advanced Placement Program		474,287		85,661
84.332	Comprehensive School Reform Demonstration		3,836,312		3,645,960
84.340	Class Size Reduction		601,875		622,431
84.348	Title I Accountability Grants		2,019,826		2,019,826
84.352	School Renovation Grants		7,729,646		7,729,646
84.357	Reading First State Grants		2,813,053		2,002,070
84.358	Rural Education		3,287,282		3,276,308
84.365	English Language Acquisition Grants		1,345,309		1,310,816
84.366	Mathematics and Science Partnerships		337,215		337,130
84.367	Improving Teacher Quality State Grants (Note 2)		51,977,126		51,811,556
84.369	Grants for State Assessments and Related Activities		2,593,220		32,566
Passed Through From Cabinet for Workforce Development:					
84.048	Vocational Education - Basic Grants to States		10,440,083		10,198,715

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

		State	Expenditures		Provided to
CFDA #	Program Title	Organizations	Cash	Noncash	Subrecipient
<u>U.S. Department of Health and Human Services</u>					
Direct Programs:					
93.576	Refugee and Entrant Assistance - Discretionary Grants		183,845		183,844
93.600	Head Start		76,792		-
93.938	Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems		481,012		381,322
Passed Through From the Cabinet for Health Services:					
93.110	Maternal and Child Health Federal Consolidated Programs		2,308		-
Passed Through From the Governor's Office of Early Childhood Development:					
93.600	Head Start		35,400		-
Passed Through From Cabinet for Health Services:					
93.945	Assistance Programs for Chronic Disease Prevention and Control		29		-
<u>U.S. Corporation on National and Community Service</u>					
Direct Programs:					
94.004	Learn and Serve America - School and Community Based Programs		250,365		254,000
TOTAL DEPARTMENT OF EDUCATION			\$ 607,975,652		\$ 593,089,795

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

Note 1 - Purpose of the Schedule and Significant Accounting Policies

Basis of Presentation - OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, requires a Schedule of Expenditures of Federal Awards showing each federal financial assistance program as identified in the *Catalog of Federal Domestic Assistance*. The accompanying schedule includes all federal grant activity for the Department of Education, except those programs administered by state universities, and is presented primarily on the basis of cash disbursements as modified by the application of KRS 45.229. Consequently, certain expenditures are recorded in the accounts only when cash is disbursed. The Commonwealth elected to exclude state universities from the statewide single audit, except as part of the audit of the basic financial statements.

KRS 45.229 provides that the Finance and Administration Cabinet may, “for a period of thirty (30) days after the close of any fiscal year, draw warrants against the available balances of appropriations made for that fiscal year, for the payment of expenditures incurred during that year or in fulfillment of contracts properly made during the year, but for no other purpose.” However, there is an exception to the application of KRS 45.229 in that regular payroll expenses incurred during the last pay period of the fiscal year are charged to the next year.

The basic financial statements of the Commonwealth are presented on the modified accrual basis of accounting for the governmental fund financial statements and the accrual basis of accounting for the government-wide, proprietary fund, and fiduciary fund financial statements. Therefore, the schedule may not be directly traceable to the basic financial statements in all cases.

Clusters of programs are indicated in the schedule by light gray shading.

Inter-Agency Activity - Certain transactions relating to federal financial assistance may appear in the records of more than one (1) state agency. To avoid the overstatement of federal expenditures, the following policies were adopted for the presentation of the schedule:

- (a) Federal moneys may be received by a state agency and passed through to another state agency where the moneys are expended. Except for pass-throughs to state universities as discussed below, this inter-agency transfer activity is reported by the agency expending the moneys.

State agencies that pass federal funds to state universities report those amounts as expenditures.

- (b) Federal moneys received by a state agency and used to purchase goods or services from another state agency are reported in the schedule as an expenditure by the purchasing agency only.

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

Note 2 - Type A Programs

Type A programs for the Commonwealth mean any program for which total expenditures of federal awards exceeded \$20 million for FY 04. The Department of Education had the following programs (cash and noncash) that met the Type A program definition for FY 04, some of which were administered by more than one (1) state agency. Certain component units and agencies audited by certified public accounting firms had lower dollar thresholds. The Commonwealth identified clusters among the Type A programs by gray shading. These Type A programs and clusters were:

CFDA #	Program Title	Expenditures
Child Nutrition Cluster:		
10.553	School Breakfast Program	\$35,722,444
10.555	National School Lunch Program	110,190,526
10.556	Special Milk Program for Children	88,468
10.559	Summer Food Service Program for Children	6,154,494
10.558	Child and Adult Care Food Program	24,372,132
84.010	Title I Grants to Local Educational Agencies	172,020,243
Special Education Cluster:		
84.027	Special Education - Grants to States	114,867,690
84.173	Special Education – Preschool Grants	10,981,242
84.367	Improving Teacher Quality State Grants	51,977,126
Total Type A Programs		<u>\$526,374,365</u>

Note 3 - Pass-Through Programs

OMB Circular A-133 Section 105 defines a recipient as “a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program” and a pass-through entity as “a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.”

Federal program funds can be received directly from the federal government or passed through from another entity. Below is a list of all federal programs that are either (1) passed through, or (2) both direct and passed through.

NOTES TO THE SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 2004

Note 3 - Pass-Through Programs (Continued)

Received From	Direct/Pass Through (Grantor #)	State Agency	Amount
<u>Fund for the Improvement of Education (CFDA #84.215)</u>			
U.S. Department of Education	Direct	EDU	\$ 531,886
Total Fund for the Improvement of Education			<u><u>\$ 531,886</u></u>

FINANCIAL STATEMENT FINDINGS

Other Matters Relating To Internal Control and/or Instances Of Noncompliance

FINDING 04-EDU-01: The Department Of Education Should Ensure That Receipts And Revenues Are Reported Correctly In The Management Administrative Reporting System

While investigating the SEFA beginning balance adjustments for CFDA's #84.011 project 35202 and #84.298 project 53303 we noticed that the cumulative revenues in the Management Administrative Reporting System (MARS) exceeded the total award for these two grants. The excess revenues were received outside of FY 04 for project 35202, but within FY 04 project 53303. The cumulative revenues and cumulative expenditures from MARS for project 53303 are summarized below by subproject.

SUBPROJECT	CUMULATIVE RECEIPTS	CUMULATIVE EXPENDITURES	EXCESS REVENUES
01	133,420.98	132,166.46	1,254.52
02	6,782,231.90	3,974,726.95	2,807,504.95
AC	87,500.00	26,759.15	60,740.85
PC	39,545.00	39,545.00	-
PO	34,998.00	34,998.00	-
TOTALS	7,077,695.88	4,208,195.56	2,869,500.32

Based upon the cumulative information in the system, it appears that \$2,869,500.32 more was received than expended. The majority of this amount relates to subproject 02 and according to the Advantage PRBL table, the entire budget has been expended and collected for this subproject while an additional \$2.7 million above the budget has been billed, but not collected. In addition, according to the SEFA, \$5,034,972 was awarded for project 53303, yet \$7,077,695.88 is reported in revenues in the system

Depending upon the situation that caused the excess billing, it is possible that Education either: 1) received \$2.04 million above the awarded amount (if cash was received), 2) overstated revenues by \$2.8 million (if the cash was not and will not be received), or 3) requested reimbursement for the same expenditures twice.

Good internal controls dictate that adequate record keeping be implemented to ensure that receipts and expenditures are recorded and reported correctly in the system.

Recommendation

We recommend that Education review the revenues and expenditures for the above project to determine the cause of the excess billings and implement corrective actions accordingly.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating To Internal Control and/or Instances Of Noncompliance*****FINDING 04-EDU-01: The Department Of Education Should Ensure That Receipts And Revenues Are Reported Correctly In The Management Administrative Reporting System (Continued)**

Management Response and Corrective Action Plan

We are in agreement that \$2.7 million above the budget amount was billed but not collected. This was due to an RE (receivable document) having been approved but not requested as a draw from the federal government. When an RE has been approved, and not requested, it does distort the revenue reports and it does appear that we received the federal funds. This should have been corrected by doing a receivable credit memo.

The SEFA was completed by using the amounts on the PRBL table, which were correct. We did not receive \$2.04 above the awarded amounts. E-GAPS, the system that is used to draw down federal funds will not allow us to draw more than is awarded. As such, the revenue was not overstated on the SEFA because the PRBL was used. Furthermore, we did not request reimbursement for the same expenditure twice.

The employee that was responsible for federal draws and the SEFA report has retired. The staff person who is now responsible, along with three other employees have recently attended MARS training on Projects and Grants. We will put into practice the procedure to monitor receipt and expenditures on a monthly basis.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating To Internal Control and/or Instances Of Noncompliance*****FINDING 04-EDU-02: The Department Of Education Should Ensure That Transfers Of Expenditures Between CFDA's Are Reported Correctly On The Schedule Of Expenditures Of Federal Awards**

As a part of this year's audit, we examined a few JVC documents that transferred expenditures between CFDA's at the end of the fiscal year and were reversed at the start of FY 05. Although these transactions are reported correctly on the federal fiscal year and although the expenditures reported on the SEFA agreed with the expenditures in MARS, the expenditures reported on the SEFA do not reflect the true expenditure activity for FY 04.

For example, at the beginning of FY 04, CFDA 84.367 received \$5,558,284 of expenditures that were transferred from 84.010 and 84.369. These expenditures, however, were not true FY 04 expenditures but were a return of FY 03 expenditures that were transferred out at the end of FY 03. At the end of FY 04, CFDA 84.367 also had \$11,254,708 of expenditures that were transferred in from 84.010 and 84.027 and these transactions were reversed in the beginning of FY 05. The net effect of these transactions was an overstatement of FY 04 expenditures of \$16,812,992 for 84.367 and an understatement of expenditures by that same amount for the other CFDA's.

When expenditures on the SEFA do not reflect the true activity for the period, this could result in expenditures being reported incorrectly to the Federal Government. In addition, if the reported expenditures are not accurate, this could result in a material misstatement of Education's SEFA. Finally, if expenditures are not reported correctly, this could adversely impact the determination of which federal programs should receive audits.

Expenditures reported to the Federal Government on the SEFA should reflect the true expenditure activity for the fiscal year.

Recommendation

Before preparing the SEFA, the Budgets Division should compile a list of these types of JVC transfer transactions to determine the net effect by CFDA for the fiscal year. Next year's SEFA preparer should then take the MARS expenditure listing and add/subtract these JVC transfers as reconciling items to the MARS totals and ensure that the expenditures reported on the SEFA reflect the actual expenditure activity for the fiscal year.

In addition, we recommend that at the end of the fiscal year, since the expenditures reported in MARS do not reflect the true activity for the year, that the Budgets Division personnel report the JVC transfer information to the Education audit manager at the APA so that federal programs can be evaluated appropriately before the start of the FY 05 Phase I and Phase II audits.

FINANCIAL STATEMENT FINDINGS***Other Matters Relating To Internal Control and/or Instances Of Noncompliance*****FINDING 04-EDU-02: The Department Of Education Should Ensure That Transfers Of Expenditures Between CFDA's Are Reported Correctly On The Schedule Of Expenditures Of Federal Awards (Continued)**

Management Response and Corrective Action Plan

KDE readily recognizes the activities noted in this record and fully understands how, without the appropriate follow-up, could be mistaken as an accurate report of expenditures on the SEFA. Therefore, we agree to follow the APA's recommendations in our efforts to be sure that expenditures on the SEFA do reflect true activity during the period and, subsequently, are reported correctly to the Federal Government.

The following actions have been put in place to implement correction to this issue:

- October, 2004 – Immediately, as a result of conversations with the SEFA auditor of the APA's Office, KDE's Director of the Division of Budgets and the Internal Policy Analyst in the Office of Internal Administration and Support (who are responsible for budget allotment, close-out, etc.) recognized the need to eliminate this type of activity if at all possible.*
- November, 2004 – Since inadequate allotment was the reason for moving expenditures to create payment ability and return when new quarterly allotment posted, KDE's Director of the Division of Budgets successfully petitioned GOPM to add additional federal allotment to the Governor's Budget Bill in hopes that passage would provide adequate payment capability both fiscal years and, subsequently, the base would be higher in future biennia.*
- February, 2005 – If, for any reason, JVC's of this nature become the only option for obtaining necessary allotment, the SEFA preparer will be advised immediately to initiate appropriate add/subtract reconciliation to the MARS total in order that actual expenditure activity for the fiscal year is reflected. In addition, the Education audit manager of the APA's Office will be notified with appropriate documentation of this activity.*

FINANCIAL STATEMENT FINDINGS***Other Matters Relating To Internal Control and/or Instances Of Noncompliance*****FINDING 04-EDU-03: The Department Of Education Should Ensure That The Support Education Excellence In Kentucky Calculations Are Reviewed Prior To Payment**

The Support Education Excellence in Kentucky (SEEK) funding program is a formula driven allocation of state provided funds to local school districts. We verified the data and recalculated the SEEK payments. During our testing of the FY 04 SEEK, we found the transportation funding for one school district was inaccurate because of a missing formula in the spreadsheet. The Tier I funding for the school district was affected because of the incorrect transportation funding.

Errors can result in incorrect calculations that affect the SEEK payments. Failure to ensure that the calculation is correct could lead to more significant monetary consequences.

Adequate review can help identify and correct errors.

Recommendation

We recommend that Education review the calculations before payment is made.

Management Response and Corrective Action Plan

The Kentucky Department of Education acknowledges and agrees with the finding on the SEEK Transportation calculation.

To avoid a similar problem in the future, KDE will continue our migration to an automated SEEK calculation system that eliminates much of the hand manipulation required by the system for 2003-2004 that resulted in a missing formula in a spreadsheet that affects a district's final transportation funding calculation. The transportation funding calculation has already been partially automated. We expect to have it completed before the 05-06 final calculations are complete in December 2005.

Although the auditor examined only a sample of the calculations, we checked the entire calculation for all school districts after the auditor found that problem. There were no other similar problems in the transportation calculation.

FINANCIAL STATEMENT FINDINGS

Other Matters Relating To Internal Control and/or Instances Of Noncompliance

FINDING 04-EDU-04: The Department of Education Should Implement Policies And Procedures For The Safe Custody And Retention Of Audit Documentation

Education uses a standard checklist based on the various KRS and KAR to conduct the attendance audits. Ten school districts from the FY 2003-2004 audits were selected for review. The results of our testing included the following exceptions:

- For one school district, the audit program could not be located;
- For one school district, the corrective action plan could not be located and the follow up was not documented;
- For all the school districts tested, the auditor was told they were reviewed, however there was no evidence of a supervisor's review.

When audit programs are missing from the files, it is difficult to determine if all required audit procedures are performed and if any corrective action or follow-up is required. In addition, if the corrective action taken by the school district and follow-up site visits performed by Education are not maintained in the files, it cannot be determined if the items needing correction were corrected.

A lack of supervisory review can cause required audit procedures to go unperformed and necessary improvements to be unnoticed.

Good internal controls dictate that documentation be maintained to provide evidence supporting the auditors' conclusions. In addition, evidence of a supervisor's review can ensure that all required tests are performed and also indicate any improvements that need to be made.

Recommendation

We recommend that Education establish policies and procedures for the safe custody and retention of audit documentation. In addition, we recommend the supervisor sign and date the audit documentation once the review is done.

Management Response and Corrective Action Plan

The Department will establish procedures to assist in the overall organization of the attendance audit documentation, as well as more effectively safeguard the documents and establish procedures to document the review of audit documentation.

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
FOR THE YEAR ENDED JUNE 30, 2004

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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Other Matters

(1) Audit findings that have been fully corrected:

FY 03	03-EDU-1	The Department Of Education Should Document Adequate Support For Expenditures Prior To Reimbursing Subrecipients	84.352	0	Resolved in FY 04.
FY 03	03-EDU-2	The Department of Education Should Adequately Follow All Instructions For The Preparation Of The Schedule Of Expenditures Of Federal Awards	N/A	0	Resolved in FY 04.

(2) Audit findings not corrected or partially corrected:

No findings to report in this category.

(3) Corrective action taken is significantly different from corrective action previously reported:

No findings to report in this category.

(4) Audit finding no longer valid:

No findings to report in this category.